FEATURE ARTICLES
MICROBANKING BULLETIN, ISSUE 14, SPRING 2007

Microfinance and its Macro-environment

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The significant rise of the microfinance industry over the past 30 years has produced an ever-increasing number of microfinance institutions (MFIs) in the developing world. Over the past ten years the industry has been supported largely by development programs and social investors. The ongoing commercialization of the industry has attracted significant capital over recent years, as the Bulletin Highlights in this issue showcases, as well as those in the previous issue[1]. Donors and investors are increasingly demanding industry rankings that allow identification of the best performing MFIs according to relevant criteria[2]. At the same time return-driven fund managers complain about the high levels of often subsidized capital available for top tier MFIs. These issues have stimulated a debate about the purpose and mission of MFIs in the developing world, which is an inherent part of the industry's transformation process.

The emergence of the microfinance industry is often explained as an answer to an unmet demand. Nevertheless, the development of the microfinance industry has been highly unequal in geographic terms. While MFIs are present in all parts of the developing world, they are much more advanced and known in some countries than others. Since financial exclusion is a phenomena existing in all developing countries, we must ask ourselves why MFIs are not more equally spread and developed around the globe?

In Latin America, for example, the progress of the industry's development has been highly uneven. Industry figures for market coverage range from 55.7% for Bolivia at the top to 0.36% in Brazil at the bottom.[3] But coverage or demand is not an appropriate indication of the degree of market development. For example, Accion's first ever Latin American microfinance experiment took place in Brazil where poverty is abundant, but its microfinance market remains insignificant compared to other countries in the region.

Too often we have to guess in order to answer such questions, loosely basing our opinion on cultural, anthropologic or historic ideas. Or we simplify the problem by arguing that some MFIs are just more successful or more profitable and better managed than others. But this is hardly satisfying, especially for an industry with a strong social aim. Other factors must play a role and need to be identified. Microfinance related academic research has so far addressed issues mostly on a country level – and almost no research exists on a comparative level.

A better understanding of the actual reasons behind the differences in the industry's development would help practitioners and academics to identify which factors are constraining the microfinance sector in specific countries. Knowledge from comparative research will also enable policy makers to focus their decisions with regard to market regulation, will enable investors to integrate microfinance as an asset class into their asset allocation strategies with an adequate risk profile, and will allow donor agencies to focus on development initiatives that address a definite need of local markets without competing with commercial investors.

In the following paragraphs, the basic hypothesis is that in some countries MFIs work better due to a more suitable (market) environment and not because of their legal status, management issues or other grounds that cannot be quantified. This article therefore aims at identifying key factors that foster microfinance markets. It remains merely a first attempt to open a broad discussion on the basis of comparative research.

The focus of this initial research is on Latin America, where microfinance markets are characterized by a

[1] Stephens, Blaine, Record Funding Fuels 2005 Growth

Even as Returns Level Off, in: MicroBanking Bulletin, Issue 13, Autumn 2006, p. 33f.

[2] Micronews, Global Microcredit Summit bulletin, Edition 2. November 13, 2006, p. 4.

[3] Marulanda, Beatriz and Maria Otero, The Profile of Microfinance in Latin America in 10 years: Vision and Characteristics, Boston, Accion International, Boston, 2005.

true array of institutions with regard to methodology, size and performance. The microfinance industry in Latin America reaches proportionally fewer clients than its counterparts in Africa or Asia, while its MFIs' average loan portfolio is the biggest of all regions. Furthermore, Latin American microfinance leverages more equity, has more assets and attracts more commercial funds than other region.[4]

Nevertheless, the unavailability of long-term data does not allow an exact computation of related factors over the years. To overcome this problem a cross-country regression is applied for one year. For this purpose we use a comprehensive dataset on the outreach of microfinance institutions in Latin America, comprising data from CGAP (2004)[5], MIX Market and other ratings agencies. The dataset used takes into account financial results of more than 270 MFIs throughout the region in 2001.[6]

The preliminary results of the research highlight five areas that deserve further research: economic instability, population density, liberalization of financial markets, international aid and regulation.

- First, microfinance tends to serve more clients in economically instable environments – an indicator of the difference between MFIs and formal financial institutions. External influences that cannot be captured with the dataset might explain the unexpected result: financial instability renders people familiar with the higher interest rates that such MFIs frequently ask in Latin America; the formal banking sector may be more reluctant to provide financial services in instable areas to the poorer sections of the population – leaving a bigger market potential for MFIs.

- Second, densely populated areas have bigger microfinance markets than those with a smaller population – confirming what practical experience has long suggested: namely, that MFIs are able to reduce their cost structures in areas with high population density. However, we also find that population density alone does not suffice as a market, for example, human capital (here measured by literacy rates) is a notable factor present in highly developed microfinance markets.

- Third, the liberalization – or privatization – of the financial sector helps foster the emergence of microfinance. Increased competition, supported by entries of foreign banks, makes commercial banks refocus on their core business – reducing downscaling efforts and thus creating a market niche for MFIs. However, experience in Latin America has also shown that increased competition in traditional banking can encourage individual commercial players to develop strong microfinance programs.

- Fourth, international aid is a significant factor for the development of microfinance markets. Countries with a large exposure to international aid programs show more developed microfinance markets than countries that receive less aid. However, the question whether international aid fosters the growth of microfinance markets or if it focuses on markets that have already developed a strong microfinance market remains unanswered. While a lot of MFIs still need external financial support, especially start-up subsidies, smart-subsidies make us wonder what part domestic governments play in attracting international aid?

- Fifth, regulation of microfinance so far is not an important factor in the development of microfinance markets. Of course, microfinance-specific regulations have mostly only been implemented over the past few years and long-term results still need to emerge from those experiments. At the same time, donors' and investors' demands of commercialization, with a focus on transparency, financial audits, ratings and other quantifiable measures, indicate the increasing self-regulation of the microfinance industry.

The issues discussed above are, of course, largely not open to manipulation by individual market players, but they indicate which factors are important

4 See Regional Benchmarking reports of the Microfinance Information Exchange at www.themix.org

5 Consultative Group to Assist the Poor (CGAP), Financial Institutions with a "double bottom line": Implications for the future Development of Microfinance, Occasional Papers, no. 8., Consultative Group to Assist the Poor (CGAP), The World Bank, Washington D.C., 2004.

6 At the time, 186 of those were operating under an NGO-status, 26 institutions were registered as commercial banks, 20 as Non-Bank Financial Institution (NBFI) and 25 as Cooperative or Credit Union. In total these institutions served 6,471,887 clients. Of course, the high savings activities of Cooperatives and Credit Unions influence the results with regard to outreach levels especially in countries with small populations. Consequently, the smallest countries were left out in the final analysis. For reasons of completeness Cooperatives and Credit Unions, as these are the oldest form of microfinance provision, were taken into account.

when analyzing the industry's macro-environment. Intervention strategies should be based on an understanding of at least the aspects raised here, globally as well as regionally, but significant and specific local influences also need to be taken into account.

In order to better understand the role of macro-economic factors in the development of microfinance markets, further research is needed. The next step will be to assemble a dataset covering a number of years. Practitioners will be contacted and asked to provide long-term data. People that have such data and are willing to share it are, of course, encouraged to contact the author. An econometric study will follow, allowing the variables to be analyzed in their historical perspectives. The ongoing study aims to identify a threshold for macro-economic and institutional factors, enabling focused intervention strategies of donors and adequate asset allocation strategies of investors. Moreover, it will also help to identify individual growth strategies for different kinds of microfinance institutions operating in different environments.

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